

EITF ABSTRACTS

Issue No. 00-22

Title: Accounting for “Points” and Certain Other Time-Based or Volume-Based Sales Incentive Offers, and Offers for Free Products or Services to Be Delivered in the Future

Dates Discussed: September 20–21, 2000; November 15–16, 2000; January 17–18, 2001; November 14–15, 2001

References: FASB Statement No. 5, *Accounting for Contingencies*
FASB Statement No. 48, *Revenue Recognition When Right of Return Exists*
FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*
FASB Technical Bulletin No. 88-1, *Issues Relating to Accounting for Leases—Lease Incentives in an Operating Lease*
FASB Technical Bulletin No. 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts*
FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*
FASB Concepts Statement No. 6, *Elements of Financial Statements*
AICPA Statement of Position No. 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*
AICPA Statement of Position No. 93-7, *Reporting on Advertising Costs*
AICPA Statement of Position No. 97-2, *Software Revenue Recognition*
AICPA Statement of Position No. 98-9, *Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions*
Proposed AICPA Statement of Position, *Accounting for Frequent Travel Awards Programs, Development and Preoperating Costs, Purchases and Exchanges of Take-Off and Landing Slots, and Airframe Modifications*, dated June 30, 1987
Proposed AICPA Statement of Position, *Accounting for Frequent Travel Awards Programs* (Proposed Amendment to AICPA Industry Audit Guide, *Audits of Airlines*), dated August 31, 1988
SEC Staff Accounting Bulletin No. 101, *Revenue Recognition in Financial Statements*

ISSUE

1. Membership-based loyalty programs have long been an integral part of many companies' incentive and customer relationship management programs. Loyalty programs currently operating in the United States serve businesses as diverse as supermarkets, telecommunications companies, airlines, hotels, automobile rental companies, credit cards, and music and book sellers. In addition, as the number of Internet users and websites increases, Internet merchants and content providers are increasingly launching and testing loyalty programs in an effort to retain their most valuable customers.

2. The general purpose of loyalty programs is to build brand loyalty and increase sales volume. Loyalty programs are structured so that a specified volume of transactions, or membership over a specified period of time, is required in order for a customer or program member to earn sufficient award credits to redeem an award. Each time a customer or program member purchases a product or service, or performs an action specified as a requirement of the loyalty program, he or she earns award credits that, subject to specified minimum thresholds, may be redeemed in the future for awards such as free, or deeply discounted, products or services.

3. Loyalty programs addressed by this Issue include (a) vendor-sponsored programs that offer awards consisting of the vendor's products or services, (b) broad-based programs operated by program operators whose business consists solely of administering the loyalty program, and (c) combination programs operated by vendors for their own customers as well as other participating vendors and their customers. Vendors that do not sponsor their own loyalty programs may participate in a loyalty program operated by either another vendor or a broad-based program operator. In such instances, the vendor

generally purchases award credits, either directly or indirectly, from the other vendor (program operator) for distribution to its customers.

4. The scope of this Issue includes vendor offers to a customer for (a) free or discounted products or services that will be delivered (either by the vendor or by another unrelated entity) at a future date (1) as a result of a single revenue transaction with the customer or (2) only if the customer completes a specified cumulative level of revenue transactions with the vendor or remains a customer of the vendor for a specified time period and (b) a rebate or refund of a determinable cash amount only if the customer completes a specified cumulative level of revenue transactions with the vendor or remains a customer of the vendor for a specified time period. The scope of this Issue also includes the accounting by broad-based program operators¹ for revenues from sales of award credits to other vendors or customers and the cost of redeeming awards.

5. The issues are:

Issue 1—How a vendor should account for an offer to a customer, in connection with a current revenue transaction, for free or discounted products or services delivered by the vendor that is redeemable (becomes earned) only if the customer completes a specified cumulative level of revenue transactions or remains a customer for a specified time period

Issue 2—How a vendor should account for an offer to a customer, in connection with a current revenue transaction, for free or discounted products or services from the vendor that is redeemable by the customer at a future date without a further exchange transaction with the vendor

¹The term *program operators* includes broad-based program operators whose business consists solely of administering a loyalty program and vendors that operate loyalty programs for their own customers as well as other participating vendors and their customers.

Issue 3—How a vendor should account for an offer to a customer to rebate or refund a specified amount of cash that is redeemable only if the customer completes a specified cumulative level of revenue transactions or remains a customer for a specified time period

Issue 4—How a vendor should account for an offer to a customer, in connection with a current revenue transaction, for free or discounted products or services delivered by an unrelated entity (program operator) under an arrangement between the program operator and the vendor that is redeemable only if the customer completes a specified cumulative level of revenue transactions or remains a customer for a specified time period

Issue 5—How a program operator should account for award credits sold (directly or indirectly) to other vendors and consumers.

EITF DISCUSSION

6. At the September 20–21, 2000 meeting, the Task Force discussed Issues 1, 2, and 3 but was not asked to reach any consensuses. For Issues 1 and 2, some Task Force members expressed a preference for an accounting approach that would allocate a portion of the revenue on the transaction to the product or service that may be delivered in the future, while other Task Force members expressed a preference for an accounting approach that would be based on the significance of the value of the award product(s) or service(s) as compared to the value of the transactions necessary to earn the award(s). If the value of the award product(s) or service(s) is insignificant in relation to the value of the transactions necessary to earn the award, a liability would be recorded for the estimated cost of the award product(s) or service(s). On Issue 3, a majority of the Task Force members expressed the view that offers for cash rebates or refunds should be classified as a reduction of revenue in the income statement. The Task Force requested

that the FASB staff, together with the Working Group established to address Issue No. 00-21, "Accounting for Revenue Arrangements with Multiple Deliverables," obtain certain additional information about loyalty program arrangements and further develop an approach to Issues 1, 2, and 3 based on the significance of the value of the award in relation to the value of the transactions necessary to earn the award.

7. At the November 15–16, 2000 meeting, the Task Force reached a tentative conclusion on Issue 3 that the vendor should recognize the rebate or refund obligation as a reduction of revenue based on a systematic and rational allocation of the cost of honoring rebates or refunds earned and claimed to each of the underlying revenue transactions that results in progress by the customer toward earning the rebate or refund. Measurement of the total rebate or refund obligation should be based on the estimated number of customers that will ultimately earn and claim rebates or refunds under the offer.

8. The Task Force also discussed the related issue of how to account for a vendor's change in estimate with respect to the number of customers that will ultimately earn and claim rebates or refunds under the offer but was not asked to reach a consensus. The Task Force asked the FASB staff to discuss this issue with the Working Group.

9. While the Task Force did not discuss Issues 1, 2, 4, and 5, the Task Force observed that any consensuses on Issue 00-21 likely would influence any proposed answers on those Issues.

10. At the January 17–18, 2001 meeting, the Task Force reached a consensus on Issue 3 that the vendor should recognize the cash rebate or refund obligation as a reduction of revenue based on a systematic and rational allocation of the cost of honoring rebates or refunds earned and claimed to each of the underlying revenue transactions that result in progress by the customer toward earning the rebate or refund. Measurement of the total

cash rebate or refund obligation should be based on the estimated number of customers that will ultimately earn and claim rebates or refunds under the offer (that is, "breakage" should be considered if it can be reasonably estimated). However, if the amount of future cash rebates or refunds cannot be reasonably estimated, a liability should be recognized for the maximum potential amount of the refund or rebate (that is, no reduction for "breakage" should be made). The ability to make a reasonable estimate of the amount of future cash rebates or refunds depends on many factors and circumstances that will vary from case to case. However, the following factors may impair a vendor's ability to make a reasonable estimate:

- a. Relatively long periods in which a particular rebate or refund may be claimed
- b. The absence of historical experience with similar types of sales incentive programs with similar products or the inability to apply such experience because of changing circumstances
- c. The absence of a large volume of relatively homogeneous transactions.

11. In some cases, the relative size of the cash rebate or refund changes based on the volume of purchases. For example, the rebate may be 10 percent of total consideration if more than 100 units are purchased but may increase to 20 percent if more than 200 units are purchased. If the volume of a customer's future purchases cannot be reasonably estimated, the maximum potential cash rebate or refund factor should be used to record a liability (20 percent in the example). In contrast, if the volume of a customer's future purchases can be reasonably estimated, the estimated amount of cash to be rebated or refunded should be recognized as a liability.

12. The Task Force reached a consensus that changes in the estimated amount of cash rebates or refunds and retroactive changes by a vendor to a previous offer (an increase or a decrease in the rebate amount that is applied retroactively) should be recognized using a cumulative catch-up adjustment. That is, the vendor would adjust the balance of its rebate obligation to the revised estimate immediately. The vendor would then reduce

revenue on future sales based on the revised refund obligation rate as computed. Exhibit 00-22A illustrates this methodology.

13. The Task Force reached a consensus that the guidance on Issue 3 should be applied no later than quarters ending after February 15, 2001. The effect of application should be reported on a cumulative basis as a reduction of revenue. Upon application of this consensus, rebate or refund amounts reported as an expense in prior-period financial statements presented for comparative purposes should be reclassified to comply with the income statement display requirements under Issue 3 (that is, presented as a reduction of revenue). If it is impracticable to reclassify prior-period financial statements, disclosure should be made of the reasons why reclassification was not made and the effect on the current period of classifying rebates and refunds as a reduction of revenue.

14. At the January 17–18, 2001 meeting, the Task Force also discussed the Working Group's observations and general direction with regard to Issue 5 but was not asked to reach a consensus. The Working Group preliminarily believes that the sale of award credits by a program operator to other vendors is a multiple-deliverable revenue arrangement in which the deliverables consist of the award product(s) or service(s) and certain other services provided by the program operator to the sponsor. If the deliverables under the arrangement cannot be identified or the fair value of the deliverables other than the award product(s) or service(s) is not determinable, Working Group members expressed a preference for developing a revenue recognition approach with respect to these loyalty program arrangements that is either similar to the residual approach² found in SOP 98-9 or based on the program operator's proportionate performance under the arrangement.

² Under the residual approach considered by the Working Group, revenue would be allocated to the award product(s) or service(s) based on its (their) fair value(s), and the difference between the proceeds from the sale of the award credits and the fair value of the award product(s) or

15. The Task Force observed that it would be preferable for the Working Group to make additional progress on the Issue 00-21 model before further developing a revenue recognition approach for Issue 5, since the resolution of Issue 5 should be consistent with the general model under Issue 00-21. [Note: See STATUS section.] In addition, some Task Force members raised questions about whether the deliverables in the arrangements under Issue 5 are separable for accounting purposes (on the basis that the services in the arrangement may be necessary to maintain the value and usefulness of the awards and the awards may be necessary to maintain the value and usefulness of the services). Some Task Force members also expressed concerns over the timing of revenue recognition associated with the estimates of program credits that will not be redeemed for awards (that is, breakage) under the revenue recognition approaches being developed by the Working Group. The Task Force requested that the FASB staff and the Working Group consider those concerns further.

STATUS

16. At the November 14–15, 2001 meeting, the Task Force discussed whether to continue work on Issues 00-21 and 00-22. The SEC Observer stated that the SEC staff would support a decision by the Task Force to continue work on those Issues. The SEC Observer also stated that the SEC staff continues to be supportive of the FASB pursuing a broad project on revenue recognition. The Task Force discussed the advantages and disadvantages of providing guidance in Issues 00-21 and 00-22 prior to the development of a comprehensive revenue recognition framework by the FASB and agreed that providing guidance on those Issues prior to completion of such a project would improve financial reporting. The Task Force agreed to first continue work on Issue 00-21 and that

service(s) would be recognized as services revenue over the average exercise period for the awards (beginning from the date the award credits are sold).

a decision on whether to continue further work on Issue 00-22 would be made after a consensus is reached on Issue 00-21.

17. At the November 14–15, 2001 meeting, the Task Force reached a consensus supporting the codification of Issues No. 00-14, “Accounting for Certain Sales Incentives,” and No. 00-25, “Vendor Income Statement Characterization of Consideration Paid to a Reseller of the Vendor’s Products,” and Issue 3 in Issue 00-22 as presented in Issue No. 01-9, “Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor’s Products).”

18. At the November 21, 2002 meeting, the Task Force agreed to discontinue further discussion of this Issue, which relates to revenue recognition. This Issue was placed on the EITF agenda prior to the Board agreeing to add to its agenda a major project on the recognition of revenues and liabilities in financial statements. That project is intended to result in a comprehensive revenue recognition standard with the objectives of (a) eliminating the inconsistencies in the existing authoritative literature and accepted practices, (b) filling the voids that have emerged in revenue recognition guidance, and (c) providing guidance for addressing issues that arise in the future.

19. No further EITF discussion is planned.

Exhibit 00-22A**EXAMPLE OF THE APPLICATION OF THE CONSENSUS ON ISSUE 3
OF ISSUE 00-22**

The following example illustrates the calculation of the effect of a change in estimate of future rebates that will be earned. The example is not necessarily intended to illustrate the only approach to formulating the estimate of the cash rebate obligation, nor does the example consider whether the company in the example can reasonably estimate the amount of rebates given the large change in estimate described in the example.

Company A, a calendar-year company, offers a 10 percent rebate to all customers who purchase at least 500 units during any calendar year (this 10 percent rebate is retroactive in that it applies to the sale of units 1 through 499 after the 500-unit level has been reached and to all units sold thereafter). Each unit's list price is \$100. Company A estimates that 650 of its 2,000 customers will purchase the number of units necessary to earn the volume rebate ("high volume" customers).

Based on that estimate, Company A records \$90 of each unit sale to a customer in the group of 650 high volume customers as revenue and \$10 as a rebate obligation. For sales to its customers that are not expected to earn the rebate, Company A records \$100 of each unit sale as revenue and does not recognize any amount as a liability under the rebate offer.

On September 30, Company A's data indicate that a higher proportion of customers are now expected to earn the rebate than previously estimated. Company A now estimates that 850 customers will earn the rebate. Assume that as of September 30, 400,000 units have been sold to the group of customers that Company A originally estimated would earn the rebate and 80,000 units have been sold to the group of customers that Company A originally estimated would not earn the rebate but now are expected to purchase the

required 500 units necessary to earn the rebate. To account for this change in estimate, as of September 30, Company A increases its refund obligation and reduces revenue by \$800,000 (80,000 units \times \$10).

As of September 30, Company A records the following journal entry:

Revenues	800,000	
Rebate Obligation		800,000

After the adjustment, Company A continues to record \$90 of each unit sale to customers in the group of 850 high volume customers as revenue and \$10 as a rebate obligation. For sales to its customers not expected to earn the rebate, Company A records \$100 of each unit sale as revenue and does not recognize any amount as a liability under the rebate offer.